STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities	))))	**Docket No. 14-0371**
Proposed General Increase In Natural Gas Rates	))	

REPLY BRIEF OF THE STAFF

OF THE ILLINOIS COMMERCE COMMISSION

(PUBLIC)

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Table of Contents

Page

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NOW COME the Staff witnesses of the Illinois Commerce Commission ("Staff"), by and through their undersigned counsel, pursuant to Section 200.800 of the Illinois Commerce Commission's Rules of Practice (83 Ill. Adm. Code 200.800), and the direction of the Administrative Law Judge ("ALJ"), respectfully submit their Reply Brief ("Staff RB") in the above-captioned matter.

I. INTRODUCTION

A. Overview

On March 31, 2014, Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities ("Liberty Midstates" or "Company")[1] filed with the Illinois Commerce Commission ("Commission") revised tariff sheets in which they proposed a general increase in gas

[1] Staff uses Liberty Midstates or Company to designate the Illinois operations.

rates pursuant to Article IX of the Illinois Public Utilities Act ("Act" or "PUA"), 220 ILCS 5/9, to become effective May 15, 2014.

B. Procedural History

On May 7, 2014, the Commission suspended the filing to and including August 27, 2014, for a hearing on the proposed rate increase. On July 30, 2014, the Commission re-suspended the tariffs to and including February 27, 2015.

Liberty Midstates and Staff submitted Initial Briefs ("IBs") in this matter. Pursuant to the schedule set by the ALJs, this RB follows.

Staff's IB identified and addressed many, if not most, of the arguments raised in the Company's IB. In this RB, Staff has incorporated many of those responses by reference or citation to Staff's IB. In the interest of brevity, however, Staff has not raised and repeated every argument and response previously addressed in Staff's IB. Thus, the omission of a response to an argument that Staff previously addressed simply means that Staff stands on the position taken in Staff's IB because further or additional comment is neither needed nor warranted.

C. Nature of Liberty's Operations

D. Test Year

E. Legal Standard

II. RATE BASE

A. Resolved Issues

1. Interest Synchronization Calculation

2. Budget Payment Plans

3. Utility Plant – Meters

4. Average Net Plant

5. Accumulated Deferred Income Taxes

6. Original Cost Determination

7. Cash Working Capital

B. Contested Issues

1. Average Net Plant

Staff has not changed its position that all items in rate base should represent the average for the test year and not the year-end balance as proposed by the Company. The Commission should adopt Staff's adjustments to present the rate base components of utility plant in service and accumulated depreciation, or net plant, as an average balance. Staff's proposal is based on the fact that investments are made throughout the test year, not at the beginning of the test year, as the Company's proposal incorrectly assumes. (Staff IB, p. 6)

In a failed attempt to justify the Company's proposal that the Commission should depart from its consistent practice of using a net plant average in rate base with a future test year, the Company states that the "evidence in this docket demonstrates that a year-end rate base is more appropriate" (Co. IB, p. 10) and that there are facts and circumstances of this proceeding that differ from the numerous rate cases where the Commission approved an average rate base with future test periods. (Co. IB, p. 11) The Company argues that "this proceeding is taking place during a period of significant increasing plant in service" and that "there is a strong likelihood the rates adopted in this proceeding will remain in effect for a number of years (Co. IB, p. 11). The company further asserts that it "has been underearning since its inception" and that use of an average plant net balance for the test year will exacerbate the effects of this underearning[,]" (Co. IB, p. 12) and would "not allow Liberty Midstates to recoup its costs of providing service." (Co. IB, p. 14)

The Company's arguments are meritless. The Company chose the future test year ending December 31, 2015. An average rate base derives rates that properly match test year revenues and expenses which will occur throughout 2015 with the level of rate base investment also occurring throughout the test year. A year-end rate base would derive revenues and expenses for 2015 which represent a level of investment that would not exist until December 31, 2015. Rates from this case will likely become effective around March 1, 2015. Thus, by using a December 31, 2015 valuation for net plant, ratepayers will pay a return on investments that the Company will not make for ten months after the effective date for new rates resulting from this proceeding. (Staff IB, p. 8) The use of a year-end valuation allows the Company to earn a return on investments before the investments have been made.

The Company contends that the particular circumstances of this proceeding justify the adoption of a year-end rate base. (Co. IB, p. 11) Unlike the other utilities that used an average rate base with a future test year, the Company claims to not have been in operation for an extended period, that this proceeding is the Company's first rate case in Illinois and that the Company has been underearning because of the long period of time between rate cases. (Co. IB, p. 12) However, this assertion should be ignored. Like the other utilities that used an average rate base, the company's Illinois service territory grew over time from individual municipalities providing gas service merging into what is currently an operating division of a utility whose parent holding company, Algonquin Power & Utilities Corp. ("APUC"), is listed on the Toronto Stock

Exchange. Prior to the Company being acquired by APUC from Atmos Energy Corporation ("Atmos") in 2012, various rate cases for the Illinois jurisdiction were filed with the last rate case filed in February, 2000. The long period of time between this rate case and the last rate case filed in February, 2000 was the result of decisions made by the prior owners. When the parent of the Company made the decision to acquire the Illinois operations of Atmos, it should have been clearly known that new rates had not been established for the Illinois jurisdiction since the 2000 rate case. That fact should have been part of the equation in setting the purchase price. This Commission has no responsibility to make the current owners "whole" for their purchase; this Commission is limited to determining a revenue requirement based on the test year data. The Company's mistaken belief that its particular circumstances of prior periods in which the company underearned is not sufficient justification for the Commission to deviate from its long-standing precedent with respect to determining a revenue requirement based upon an average rate base in future test years.

The Company further attempts to differentiate itself from other utilities by arguing that "the Company's projects are not large enough for it to access the capital markets each time it initiates a project, nor is it constantly accessing the capital markets such as larger utilities may do with shelf registrations." (Co. IB, p. 13) If this argument has a basis, it is up to the Company to file more frequent rate cases. The Commission cannot set rates to fund future plant additions so that the Company doesn't have to access the capital markets.

2. Accumulated Deferred Income Taxes

Staff maintains its position on this issue. (Staff IB, p. 8) The Commission should adopt Staff's adjustments to establish ADIT as a prorated average balance rather than as a year-end balance as proposed by the Company. In rebuttal testimony, the Company agreed that Staff's proration of the test year-end ADIT balance is in compliance with Section 168(i)(9)(B) of the Internal Revenue Code, but continues to contest the use of an average balance. (Co. Ex. 5.0, p. 11) The discussion on the basis of using average ADIT as a component of an average rate base is the same as above in Section II. B. 1. Average Net Plant.

3. Incentive Compensation[2]

Staff maintains its position on this issue. (Staff IB, p. 15) The Company disagrees with Staff that basing incentive compensation on financial metrics do not benefit customers. (Co. IB, p. 28) The Commission should adopt Staff's adjustments to reduce the Company's operating expenses and rate base for incentive compensation costs that do not provide tangible benefits to ratepayers. As set forth in Staff's IB, the Company fails to demonstrate how such incentive compensation costs produce tangible benefits to ratepayers. This criteria for rate recovery – the utility demonstration of tangible benefits to ratepayers – has been established in numerous Commission orders. (Staff IB, p. 16)

C. Recommended Rate Base

Staff continues to recommend a rate base of $39,418,167 as reflected on page 5 of Appendix A to Staff's IB. Staff's recommendation is $504,232 less than the $39,922,399 rate base requested by Liberty Midstates in rebuttal.

[2] Due to the capital component.

III. OPERATING REVENUES AND EXPENSES

A. Resolved Issues

1. Property Taxes – Test Year Expenses

2. Outside Professional Services

3. Rate Case Expense

4. Allocation from Shared Services ("LABS")

5. Depreciation Expense

B. Contested Issues

1. Gross Revenue Conversion Factor

a. Uncollectible Expense Rate

The Commission should adopt Staff's 0.51% uncollectible expense rate for inclusion in the gross revenue conversion factor ("GRCF") and as the percentage of revenues to be considered as uncollectible expense. (Staff IB, pp. 13-14; Staff Sched. 6.08) Liberty Midstates fails to demonstrate that its proposed rate of 0.70% is a representative rate for test year purposes. (Co. IB, p. 22) Instead, the Company merely attempts to confuse the record. Staff will not address each point discussed in the Company's IB, but notes the following flaws in Liberty Midstates' arguments.

First, the Company claims that "the five-year average ignores the more recent data used by the Company which indicates a higher level of uncollectibles". (Co. IB, p. 23) In fact, the five-year average proposed by Staff does not ignore the most recent data. As shown in Staff Schedule 6.08, 2013, the most recent year for which data is available, is included in column (b) and is included in the determination of the five-year average. Accordingly, Staff's proposed uncollectible rate includes, and gives equal weight to, the five most recent years 2009-2013. (Staff Sched. 6.08)

Furthermore, the suggestion that the higher uncollectible rate experienced in 2013 "…indicates a higher level of uncollectibles" (Co. IB, 23) is completely unsupported and misleading. The Company did not present any statistics or studies to show that a higher-than-normal uncollectible rate in one year is indicative of (higher) future uncollectible rates. The Company urges the Commission to believe that a single data point of recent data is a more reliable predictor of uncollectible rates than a five-year history. The evidence, however, suggests precisely the opposite conclusion; at the very least it suggests that uncollectible rates vary from year to year. Otherwise the 0.62% rate shown for 2009 would have trended higher each successive year, but that has not happened. Staff Schedule 6.08 shows that uncollectible rates for the five year period from 2009 to 2013 are the following:

Year	Rate
2009 (Atmos)	0.62%
2010 (Atmos)	-0.07%
2011 (Atmos)	0.50%
2012 (Atmos partial year)	0.55%
2012 (Liberty partial year)	0.36%
2013 (Liberty)	1.03%

There is no evidence that the uncollectible expense rate has trended higher since 2009 and there is no evidence that more recent data is more reliable in the determination of the test year uncollectible expense rate.

Second, the Company's statement that "Staff's five-year average relies primarily on data from a different company" is a red-herring and should be ignored by the Commission because it has no significance. (Co. IB, p. 23) The important facts are the following as it relates to the determination of the uncollectible expense rate in the instant proceeding:

1. The service territory is the same (regardless whether being served by Atmos Energy Corporation or Liberty Midstates);

2. The customers are the same;

3. The customer mix is the same; and

4. The rate structure is the same.

The only change is the name of the utility on the customers' bill, from Atmos to Liberty Midstates.

The third point of contention raised by Liberty Midstates is that some of the data included in Staff's analysis is allegedly questionable. It is not. Staff relied on the Form 21 ILCC annual reports submitted by the Company's predecessor in interest to the Commission, which have been verified by an officer of the reporting company. Specifically, Liberty Midstates questions Atmos' 2010 negative uncollectible rate (-0.07%). There may be valid reasons why the rate is negative. In any case, those issues were not raised in this case. Furthermore, it can only be assumed that during the acquisition due diligence process, any concerns with the prior financial records of Atmos' were considered and reflected in the purchase price of the Atmos service territory approved by the Commission in Docket No. 11-0559.[3]

Finally, Liberty Midstates attempts to distinguish the instant case (which uses a future test year) from the six cases cited by Staff witness Knepler where the Commission used a five-year average to set the uncollectible rate. Of the six cases

[3] Atmos Energy Corporation and Liberty Energy (Midstates) Corp, Application for Approval of Proposed Organization and Other Relief, ICC Docket No. 11-0559, Order Date June 27, 2012.

cited by Mr. Knepler only one case used a future test year. (Staff Ex. 6.0, p. 8) Liberty Midstates fails to demonstrate why the choice of future test year or historical test year is significant. (Co. IB, p. 24)

The test year selected by the Company is not a determining factor in whether the Commission considers a five-year average in setting the uncollectible expense rate because the revenue requirement and rate design are set to recover operating expenses and provide for a return on investment. Furthermore, the underlying concern for the Commission is that its Orders be supported by the evidence. A five-year average uncollectible expense rate provides evidence for the Commission such “that a ‘reasonable mind would accept as sufficient to support a particular conclusion’”. (ComEd, 398 Ill. App.3d 510, 514 (2nd Dist. 2009)) Therefore, Staff’s proposed 0.51% uncollectible rate is objective, verifiable and supportable and should be adopted by the Commission.

b. State Income Tax Rate

As noted in Staff’s IB, the record remains open in this proceeding and the Administrative Law Judge has instructed the parties to provide briefs should the Legislature address the expiration of the Illinois state income tax rate. (Tr., 33-34:24-21, Oct. 16, 2014) Therefore, and based upon those instructions, Staff believes the state income tax rate is not a disputed issue. (Staff IB, p. 15)

2. Incentive Compensation

See Rate Base Section II. B. 3.

C. Recommended Operating Income / Revenue Requirement

Staff recommends a revenue requirement of $12,021,409, an increase of $4,439,655 or 58.56% in base rates. The above revenue requirement produces an operating income of $2,684,377.

IV. RATE OF RETURN/COST OF CAPITAL

Staff witness Rochelle M. Phipps continues to recommend a 6.81% overall cost of capital for the Company's gas delivery services, which reflects a 9.23% cost of common equity, as shown below.

Liberty Utilities (Midstates Natural Gas) Corp.
Weighted Average Cost of Capital (WACC) Summary
Summary of Staff Proposal

Capital Component	Weight	Cost	Weighted Cost	Revenue Conversion Factor	Pre-Tax WACC
Short-Term Debt	0.46%	1.41%	0.01%	1	0.01%
Long-Term Debt	53.95%	4.81%	2.59%	1	2.59%
Common Equity	45.59%	9.23%	4.21%	1.6509	6.95%
Total	100.00%		6.81%		9.55%

(Staff Ex. 8.0, Sch. 8.01)

A. Resolved Issues

1. Short-Term Debt Ratio

2. Cost of Short-Term Debt

3. Embedded Cost of Long-Term Debt

B. Contested Issues

1. Common Equity and Long-Term Debt Ratios

Section 9-230 of the Public Utilities Act ("Act") prohibits the Commission from combining Liberty Midstates' actual capital structure, which comprises 60.10% common equity, and LUC's cost of debt. (Staff IB, pp. 19-20) Towards that end, all three benchmarks cited by the Company as "meaningful benchmarks that may inform the Commission's decision", and which range from 50.07% to 56.40%, would be impermissible under Section 9-230 of the Act because they exceed the actual common equity ratio of LUC, which serves as the upper bound on permissible common equity ratios. (Co. IB, p. 38) Even if the Company's claims that its actual capital structure "is the correct capital structure for purposes of ratemaking in this case" (Co. IB, p. 38) and it is "just, reasonable, and consistent with relevant and observable benchmarks" (Co. IB, p. 30), were correct - which they are not - Section 9-230 of the Act absolutely precludes adoption of such a capital structure. The Illinois Appellate Court has made clear the absolute and mandatory nature of Section 9-230:

> Section 9-230 does not allow the Commission to consider what portion of a utility's increased risk or cost of capital caused by affiliation is "reasonable" and therefore should be born by the utility's ratepayers; the legislature has determined that any increase whatsoever must be excluded from the ROR determination. *It is impermissible for the Commission to substitute its reasonableness standard for the legislature's absolute standard.* The Commission may not define a portion of the Act in a way that conflicts with a specific directive contained in the Act. [citation] We hold that if a utility's exposure to risk is *one iota greater*, or it pays *one dollar more for capital* because of its affiliation with an unregulated or nonutility company, the Commission must take steps to ensure that such increases do not enter in its ROR calculation.

(*Illinois Bell Telephone Co. v. Illinois Commerce Comm'n*, 283 Ill. App. 3d 188, 207, 669 N.E.2d 919, 933 (2nd Dist. 1996) (emphasis added; citation omitted).)

Two things are apparent from this holding. First, the Commission cannot consider the Company's actual capital structure unless it makes a threshold determination that this capital structure in question satisfies the requirements of Section 9-230. Second, Section 9-230 absolutely bars, as a matter of law, the adoption of a capital structure which, as a result of affiliation, results in increased risk or increased cost of capital. In other words, the arguments put forth by the Company regarding the reasonableness of its actual capital structure cannot be considered, given the absolute mandate of Section 9-230.

The Company claims that Staff's proposed imputed capital structure is "without any support from … Commission precedent." (Co. IB, pp. 30, 39) To the contrary, the Commission has adopted imputed capital structures for ratemaking purposes in those circumstances in which Section 9-230 of the Act prohibits using the utility's actual capital structure. (See, *e.g.*, <u>North Shore Gas Co. and The Peoples Gas Light and Coke Co.</u>, ICC Docket Nos. 11-0280/11-0281 (Consol.), 108-109 (Jan. 10, 2012); <u>Ameren Illinois Co.</u>, ICC Order Docket No. 12-0293, 106 (Dec. 5, 2012); <u>Ameren Illinois Co.</u>, ICC Order Docket No. 12-0001, 128 (Sept. 19, 2012).) Specifically, the Commission's Order in Docket No. 12-0293 states:

> AIC and Staff raise arguments on this issue very similar, and in some cases identical, to those they raised in Docket No. 12-0001…[.] AIC proposes using a December 31, 2011 capital structure, which comprises 54.85% common equity. Staff measured a 53.26% average 2011 common equity ratio. Staff contends that neither of those capital structures would be appropriate for setting rates because both produce a rate of return that would violate Section 9-230 of the Act given that Ameren, AIC's parent company, had an average 2011 common equity ratio of 51.05% over the same measurement period. Because Illinois law bars the Commission from including any increased cost of capital resulting from a public utility's affiliation with any unregulated or non-utility companies, Staff insists that an adjustment to AIC's capital structure is necessary.
> <u>Ameren Illinois Co.</u>, ICC Order Docket No. 12-0293, 106 (Dec. 5, 2012).

Staff's imputed capital structure, comprising a 54.41% debt to capitalization ratio (Staff Ex. 8.0, Sch. 8.01) comports with the Company's own target debt ratio. Specifically, the Company forecasts a [**begin confidential**] XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

XXX [**end confidential**]. That is, Liberty's parent company Algonquin Power and Utilities has informed the credit rating agencies what debt ratio range it believes is appropriate for its utility business. (Staff Ex. 8.0, p. 14) Notably, Staff's proposal is similar to the target that APUC established for LUC.

Moreover, Staff observes that if the goodwill is removed from the Company's common equity balance, which typically occurs in Illinois ratemaking proceedings, the Company's common equity ratio falls from 60.10% to 43.98%. This is even lower than Staff's recommended equity ratio of 45.59%. (Staff Ex. 8.0, p. 15)

The Company asserts that, "[a]uthorizing an equity ratio below the Company's current actual equity ratio (and below the equity ratios in place at the proxy group companies) would increase the Company's financial risk, and serve to exacerbate the Company's elevated risk relative to the proxy group." (Co. IB, pp. 32-33, 35-36) This assertion should be ignored.

Foremost, issuer credit ratings reflect the combined business risk and financial risk of an entity. The average credit rating for the proxy group is A-. The average credit rating for the gas distribution utility industry is A-. No adjustment to the sample average common equity ratio would be necessary if LUC were also rated A-; however, LUC's BBB credit rating is lower than the average credit rating of the proxy group. Therefore, LUC is paying higher interest rates on its debt than it would have had it been rated A-. Combining LUC's embedded cost of debt, which reflects its BBB rating, to a capital structure that supports an A- credit rating, would result in a mismatch between the cost of debt and the average equity ratio of the proxy group and the cost of equity estimate derived from that proxy group.

This being the case, it is necessary to lower the common equity ratio and raise the cost of equity estimate for LUC in order to align the cost of equity, cost of debt and capital structure and to ensure those reflect the risk inherent in a BBB/Baa-rated gas utility. Although relying on benchmarks for the debt to equity ratio and using bond yields to adjust the cost of equity are not perfect proxies (of which none exist), they provide reasonable estimates that the Commission has adopted in the past. (Staff Ex. 8.0, p. 9)

Second, it is important to assess the financial strength implied by a recommended rate of return on rate base by comparing three Standard & Poor's ("S&P") financial benchmarks to the implied financial metrics for LUC, based on that proposal. Specifically, S&P publishes benchmarks ranges for the following three financial metrics: (1) Debt to Capital; (2) Debt to Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA"); and (3) Funds From Operations ("FFO) to Debt. The table below summarizes the results of Ms. Phipps' evaluation. (Staff Ex. 8.0, p. 30)

Table One: S&P Financial Benchmarks vs. LUC's Implied Financial Strength

		S&P Financial Benchmarks		
Financial Metric	LUC	Intermediate	Significant	Aggressive
Debt to Capital	54.4%	35-45%	45-50%	**50-60%**
Debt to EBITDA	3.16x	**2-3x**	**3-4x**	4-5x
FFO to Debt	22%	30-45%	**20-30%**	12-20%

Overall, LUC's implied financial strength is significant. According to S&P, a significant financial risk profile, combined with LUC's business risk profile of "Strong" corresponds to an implied S&P credit rating of BBB. Thus, Ms. Phipps' proposal should not have any negative effect on the financial strength of LUC. (Staff Ex. 8.0, p. 30)

The Company disagrees with Ms. Phipps' position that the Company's capital structure is unreliable. (Co. IB, pp. 33-34) However, the company's assertions are seriously flawed. In addition to the problems identified in Staff's brief (Staff IB, pp. 20-21), the Company incorrectly characterized the credit facility borrowing, with a maturity date more than one year from the issuance date, as "short-term debt," which is defined by Commission rule as debt maturing <u>within</u> one year after the issue date. 83 Ill. Adm. Code 285.115. The Company also provided inconsistent information regarding its outstanding indebtedness. Despite acknowledging that it had a revolving credit facility borrowing of $3,660,923 as of December 31, 2013, the Company later revised its position, stating, "To the extent the Company has previously indicated that it did draw down or maintain balances on this revolving credit facility, it was incorrect and those indications should be revised." (Staff Ex. 8.0, pp. 5-6)

The Company alleges that authorized equity ratios since January 2013 for BBB-rated natural gas utilities exceed Staff's proposed common equity ratio and, thus, call into question Ms. Phipps' recommendation. (Co. IB, pp. 36-37) Even if the Commission were to consider the equity ratios and ROEs authorized in other jurisdictions, which it rightly does not, Mr. Hevert has not provided the information necessary for the Commission to determine whether the facts and circumstances in any of the decisions he cites are relevant to the Commission's decision in this case. (Staff Ex. 8.0, pp. 11-12) Examples of such facts and circumstances include, but are not limited to:

- Whether the authorized rate of return is for gas operations only;
- Ratemaking adjustments *(e.g.*, removal of goodwill and the effect of affiliates that increase the cost of capital);
- Whether authorized rate of return is determined using a formula rather than financial analysis to estimate the investor-required rate of return; and
- Models relied upon to estimate the investor-required rate of return.

There are other problems which reduce the usefulness of the authorized ROEs cited by the Company for assessing the reasonableness of Ms. Phipps' cost of equity estimate. First and foremost, Section 9-230 of the Act prohibits the Commission from combining Liberty Midstates' capital structure with LUC's cost of debt and requires that the Commission remove the last iota of incremental cost due to Liberty Midstates' affiliation with LUC. Quite simply, capital structures approved in other jurisdictions, subject to different laws, are not relevant.

Further, in Company Schedules 7.13 and 10.3, the Southwest Gas Corp. decision (with a 10.10% ROE and a 55% common equity ratio) was a single rate case for three service areas. Thus, Mr. Hevert's average ROE and authorized equity ratio calculation is overstated due to overweighting the 2014 Southwest Gas Corp. rate decision. That case also reflects a projected capital structure because the company operates on a five-year general rate case cycle (meaning the company will file its next rate case in 2017 with a 2019 test year) and an authorized ROE that the California

Public Utilities Commission recently authorized for another California gas utility.[4] (Staff Ex. 8.0, pp. 12-13) Additionally, the 2014 Wisconsin Power and Light Company decision (with a 10.40% ROE and a 50.46% equity ratio) cannot be used to assess the reasonableness of Staff's proposal in this case because that decision applies to gas and electric base rates. Moreover, the authorized ROE and equity ratio in that case are also carryovers from the company's prior rate decision.[5] (Staff Ex. 8.0, p. 13)

Finally, the Company attempts to call into question the methodology Ms. Phipps used to adjust the average common equity ratio of the proxy group so that it would reflect LUC's riskier credit rating. (Co. IB, pp. 36-37) Foremost, Mr. Hevert first raised the arguments described in the Company's brief in surrebuttal testimony (Co. Ex. 10.0, pp. 7-11), even though those arguments responded to an adjustment set forth in Staff's direct testimony (Staff Ex. 3.0, pp. 5-6), which in Staff's view is improper. It is improper because Staff was denied an opportunity to address and expose these arguments as baseless in Staff's rebuttal testimony. Moreover, nothing in Mr. Hevert's surrebuttal, or any other record evidence, suggests the standard rating agency adjustments identified by Mr. Hevert vary based upon a company's capital structure. In other words, the midpoint of the debt to capitalization ratio range for an A rating would remain 9.5 percentage points from the midpoint of the debt to capitalization ratio range for a Baa

[4] Decision 14-06-028, by the Public Utilities Commission of the State of California, regarding Application 12-12-024 Application of Southwest Gas Corporation for Authority to Increase Rates and Charges for Gas Service in California (June 12, 2014); Decision 12-12-034, Public Utilities Commission of California, regarding Application 12-04-015 Application of Southern California Edison Company for Authority to Establish its Authorized Cost of Capital for Utility Operations for 2013 and to Reset the Annual Cost of Capital Adjustment (Dec. 20, 2012).

[5] Final Decision 6680-UR-119, by the Public Service Commission of Wisconsin, regarding Application of Wisconsin Power and Light Company Regarding the 2015 Test Year Electric and Natural Gas Base Rates.

rating regardless of how Moody's calculates the debt ratio for any particular company. Thus, the Company's arguments are infirm.

Notwithstanding the Company's improper surrebuttal, Staff recognizes that the Company's ratemaking capital structure differs from how Moody's calculates its benchmark ratios. As such, Ms. Phipps used the proxy group's average common equity ratio as the starting point for the imputed capital structure rather than the common equity ratio implied by the Moody's benchmark debt to capitalization ratio. (Staff IB, p. 22) Despite the Company's claim that it is unclear whether Ms. Phipps relied on Moody's "Standard Grid" or "Low Business Risk Grid" (Co. IB, p. 36), Ms. Phipps testified that Moody's views natural gas local distribution companies as having low business risk. (Staff Ex. 8.0, p. 24)

In summary, Staff proposes a 45.59% common equity for ratemaking purposes, which Ms. Phipps adjusted based on LUC's BBB credit rating. (Staff IB, p. 22) Under Section 9-230 of the Act, the Company's ratemaking capital structure cannot have a higher common equity ratio than LUC because the rate of return on rate base reflects the cost of debt for BBB-rated LUC. (Staff IB, p. 20) That is, LUC's actual common equity ratio serves as a cap on the Company's allowable common equity ratio for ratemaking purposes.

In addition to satisfying the requirements of Section 9-230 of the Act and the need for transparency when the Commission authorizes a rate of return for an Illinois public utility, Staff's proposed capital structure reflects a common equity ratio that is only [**begin confidential**] XXXXXXXXXXXXXX [**end confidential**] lower than LUC's actual common equity ratio. (Staff IB, pp. 19, 23) Nothing in the record indicates the small difference between LUC's actual common equity ratio and Staff's imputed capital structure is likely to result in a credit rating downgrade for LUC. To the contrary, Staff's recommended debt ratio is within the target range for LUC (Staff IB, p. 23) and Staff's recommended capital structure, in conjunction with its recommended rate of return on common equity, is consistent with LUC's BBB credit rating. (Staff Ex. 8.0, p. 30) Thus, not only does Staff's recommended rate of return meet the requirements of Section 9-230 of the Act, it is reasonable as well. For all the foregoing reasons, as well as those set forth in Staff's Initial Brief (pp. 19-23), the Commission should adopt Staff's proposed capital structure for the Company.

2. Cost of Common Equity

The Company disagrees with Staff's 9.23% cost of equity (or "ROE") recommendation and argues that it is well below the average authorized natural gas ROE since January 2013 of 9.65%. (Co. IB, p. 39, 53) To the contrary, Staff's recommendation in this case is similar or higher than recent authorized natural gas ROEs in Illinois. Specifically, in Docket No. 11-0282, the Commission approved a 9.06% ROE for Ameren Illinois Company's gas distribution operations, and in Docket No. 13-0192, the Commission approved a 9.08% ROE for Ameren Illinois Company's gas distribution operations. <u>Ameren Illinois Co.</u>, ICC Docket No. 13-0192, 166-167, (Dec. 18, 2013); <u>Ameren Illinois Co.</u>, ICC Docket No. 11-0282, 127 (Jan. 10, 2012). In Docket Nos. 12-0511/12-0512 (Cons.), the Commission authorized a 9.28% ROE for the gas operations of The Peoples Gas Light and Coke Company and North Shore Gas Company. <u>North Shore Gas Co. and The Peoples Gas Light and Coke Co.</u>, ICC Docket Nos. 12-0511/12-0512 (Cons.) 208-209 (June 18, 2013).

Mr. Hevert recommends a 10.50% ROE after performing various analyses with results ranging from 9.28% to 13.49%. Mr. Hevert's only rationale for that ROE recommendation is that it "falls within his recommended range of 10.00% to 10.50%," which is also based on Mr. Hevert's judgment alone. (Co. IB, pp. 42-43; Co. Ex. 7.0 Rev., pp. 5-6) Likewise, Mr. Hevert claims he considered the Company's size, the regulatory environment in which the Company operates, weather variability and flotation costs. (Co. IB, p. 39) He also calculated a flotation cost adjustment of 15 basis points (0.15%) (which he lowered to 0.13% in rebuttal testimony). (Co. Ex. 4.0, p. 57; Co. Ex. 7.0 Rev., p. 55) Yet, Mr. Hevert did not propose a specific adjustment to his ROE recommendation for size, regulatory environment, weather risk or flotation costs, but rather made a subjective judgment. (Co. Ex. 4.0, pp. 38, 42-43, 45) The Commission requires detailed justification for departing from the results of cost of equity models and "that the explanation be rational and aimed at serving both the ratepayer and the shareholder by setting a return sufficiently high that the utility can attract capital, but not so high that it earns an excessive return." Central Illinois Light Co., ICC Docket No. 94-0040, 65 (Dec. 12, 1994). The Company has failed to support its 10.50% ROE recommendation; therefore, it should be rejected.

The Company acknowledges that the Commission relies on the results of specific cost of equity models, rather than subjective estimates, when it states, "recent Commission orders have shown a preference towards using an average of the parties DCF and CAPM – *i.e.*, taking the average of the ROE witnesses' DCF results and combining that with the average of ROE witnesses CAPM results and dividing by two." (Co. IB, p. 41) The Company's statement does not accurately describe the ROE decision in the last two rate cases in which Mr. Hevert himself was the cost of equity witness. In Docket Nos. 13-0192 and 11-0282, the Commission combined Staff's CAPM results with the average DCF results. Ameren Illinois Co., ICC Docket No. 13-0192, 162-166, (Dec. 18, 2013); Ameren Illinois Co., ICC Docket No. 11-0282, 127 (Jan. 10, 2012). Should the Commission wrongly accept the unsustainable growth rates with which Mr. Hevert inflated his DCF results and apply the same methodology in this case - which it should not - it would result in an ROE of 9.26%, which would have to be raised by 31 basis points to account for the difference in the credit ratings of LUC versus the proxy group. (Staff Ex. 8.0, p. 3) Thus, the resulting ROE would be 9.57% - not 9.82% as the Company claims. (Co. IB, pp. 41-42)

A. Discounted Cash Flow Analysis

1. SV Factor in the Retention Growth Rate Estimate

The Company objects to removing the SV factor from its Retention Growth Estimate and argues that Value Line projects certain proxy group companies to increase their common shares outstanding. (Co. IB, p. 45) The Company's argument, however, ignores that the SV formula only applies to new shares that are issued at the market price, and that Value Line, which provides Mr. Hevert with his projection of new common share issuances, forecasts that none of the sample companies will issue new shares at the market price. (Staff Ex. 3.0, p. 13)

2. Long-Term Growth Rate Estimate

The Company claims that Ms. Phipps' 4.57% nominal long-term GDP growth estimate is "unreasonably low nominal growth rate in the context of historical growth rates." (Co. IB, p. 47) The Company claims that Mr. Hevert cited to several examples industry literature indicating that investors expect companies to grow at historical average rates. (Co. IB, p. 47) However, Mr. Hevert does not present any evidence that directly applies to utilities or that occurs in an environment like today's market. The Baron Fund quarterly report cited by Mr. Hevert is not specific to utilities, which have lower growth rates than the market as a whole. Mr. Hevert also cites a financial text by Eugene F. Brigham and Michael C. Ehrhardt that states dividend growth for most mature firms is expected to continue at about the same rate as nominal GDP (real GDP plus inflation), or 5% to 8% a year. (Co. Ex. 10.0, pp. 27-28) First, the record does not specify the age of the nominal GDP growth rate estimate in the Brigham text book; that is, is the growth rate range from 2014 or is it older? As will be shown below, the forecast range is consistent with an estimate Brigham provided 20 years ago. Second, there is no evidence that Brigham and Ehrhardt have any expertise in economic forecasting. For example, even with a real GDP growth rate estimate as high as Mr. Hevert's 3.27%, an inflation rate of 4.73% would be necessary to achieve a nominal GDP growth rate of 8%. Given consensus estimates of long-term inflation of 2.3%-2.4%, the Brigham/Ehrhardt range is not plausible. Third, when Brigham estimated long-term nominal GDP growth in 1994, he used an inflation rate of 4% and a real GDP growth rate of 2%. <u>Commonwealth Edison Co.</u>, ICC Docket No. 94-0065, 1995 Ill. PUC Lexis 25, *174 (Jan. 9, 1995). Therefore, with today's lower long-term inflation rate of 2.3%-2.4% (which is not a point of dispute between Staff and the Company), Brigham's long-term nominal GDP growth rate would be 4.3%-4.4% today. Regardless, in the 1994 case, the Commission determined that Mr. Brigham's growth rates were "excessively high". Commonwealth Edison Co., ICC Docket No. 94-0065, 1995 Ill. PUC Lexis 25, *199 (Jan. 9, 1995).

Furthermore, the Company's claim that it is reasonable to assume future real GDP growth will reflect historical real GDP growth is incorrect. (Co. IB, p. 54) Mr. Hevert attempted to support this claim by graphing annual real GDP growth rates from a subset of the measurement period he used to calculate his historical real GDP growth rate. (Co. Ex. 7.0 Rev., p. 33) Yet, Mr. Hevert's graphs do not answer the question of whether historical realized real GDP growth over either measurement period reflects investor expectations of long-term real GDP growth. Blue Chip Financial Forecasts estimates real GDP will average 2.4% for 2020-2024, which is identical to the real GDP projections Ms. Phipps relied upon, and is far below the 3.27% historical average relied upon by Mr. Hevert. As Ms. Phipps demonstrated in testimony, real average realized GDP has declined since 1948 (*see* Chart Two in Staff Ex. 8.0, pp. 17-18), whereas Mr. Hevert's model assumes it will rise.

3. 69.45% Payout Ratio

The Company assumes earnings growth and dividend payout ratios will revert toward long-term observed historical averages over time. (Co. IB, p. 54) Ms. Phipps explained why it is problematic that Mr. Hevert's DCF analysis models an increasing payout ratio with accelerating sustainable growth. (Staff IB, p. 33) Importantly, a higher dividend payout ratio requires a lower percentage of earnings retained to common equity (*i.e.*, the retention ratio). (Staff IB, p. 33) Yet, Value Line projects increasing retention ratios for the proxy group companies, rather than a retention ratio that reverts to an ad hoc mean, as Mr. Hevert's model assumes. (Staff Cross Ex. 7)

Further, the Company's reliance on historical data is problematic because it reflects conditions that may not continue in the future. Specifically, using average historical data implies reversion to a mean and, even if payout ratios were mean reverting, there is no method for determining the true value of that mean let alone the length of time over which mean reversion will occur. Thus, any measurement period chosen is arbitrary, rendering the results uninformative. (Staff Ex. 8.0, pp. 16-17)

The Company objects to Staff's DCF analysis holding the proxy group companies' dividend payout ratio at the 2017-2019 level, arguing it is reasonable to use historical data to estimate dividend payout ratios, thereby assuming current payout ratios will increase over time. (Co. IB, p. 46) However, the company is incorrect; it is not problematic to assume that a payout ratio will stabilize at the 56% level Value Line forecasts. Financial theory recognizes that investors are indifferent as to whether they receive their return on an investment in the form of dividends or through capital appreciation. This implies that the dividend payout ratio does not affect common stock prices or the cost of common equity. (Staff Ex. 8.0, p 17)

However, assuming a higher dividend payout ratio requires a lower long-term growth estimate (Staff IB, p. 33), whereas Mr. Hevert's DCF analysis models increasing payout ratios in combination with increasing retention ratios, which contradicts financial theory.[6] (Staff IB, p. 33) If Mr. Hevert's model held the dividend payout ratio at Value

[6] Growth rate = (1-dividend payout ratio) × ROE (see Staff Ex. 3.0, p. 14, fn 28, and Co. Ex. 4.0, pp. 21-22). Thus, the growth rate and the dividend payout ratio are inversely related: the higher (continued…)

Line's forecasted 2017-2019 level (instead of creating his own forecasted increase equal to an ad hoc historical industry average payout ratio by 2024), his DCF analysis would have produced a return on equity estimate of 9.25%, even while retaining his long-term growth estimate of 5.72% and the "SV" factor in his Retention Growth Estimate. (Staff Ex. 8.0, pp. 16-17)

B. Risk Premium Analysis

1. Forecasted U.S. Treasury Bond Yield

Mr. Hevert's CAPM should be rejected, in part, because he relies upon a forecasted U.S. Treasury bond yield as a proxy for the risk-free rate of return. (Staff IB, pp. 33-35) Nevertheless, the Company observes that, "Ms. Phipps calculates an implied 20-year forward U.S. Treasury yield in ten years of 4.27 percent as part of her calculation of expected inflation using the TIPS spread; that estimate is 71 basis points above the 3.56 percent 30-day average 20-year Treasury yield as of the same date." (Co. IB, p. 49) The Company claims that calculation shows an expectation of rising interest rates. (Co. IB, p. 49) However, the implied 20-year forward rate is not expected to occur for another 10 years and, therefore, is not a reasonable proxy for today's risk-free rate. (Staff Ex. 8.0, p. 21)

The Company also asserts that forecasts of the 30-year U.S. Treasury bond yield indicate investors expect interest rates to rise; therefore, the Company concludes, "it is appropriate to consider both current and projected 30-year U.S. Treasury bond yields

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the dividend payout ratio, the lower the growth rate; the lower the dividend payout ratio, the higher the growth rate.

when estimating the risk-free rate component of the CAPM." (Co. IB, pp. 49-50) Mr. Hevert relied upon the forecasted 30-year U.S. Treasury bond yield published in Blue Chip Financial Forecast. Certain data included in Blue Chip Financial Forecast may serve as proxies for investor expectations; however, the forecasters are economists rather than investors. Mr. Hevert's argument does not recognize this distinction. (Staff Ex. 8.0, pp. 21-22)

2. Market Rate of Return

The Company argues the market risk premiums, or "MRP" estimates in Mr. Hevert's analysis are reasonable relative to historical MRP. (Co. IB, p. 51) Staff has provided numerous reasons the results of Mr. Hevert's market return analyses are questionable at best and, thus, should be disregarded. (Staff IB, pp. 35-36) Yet, to support his MRP estimates, Mr. Hevert produced a histogram of annual MRP over the 1926-2013 period and calculated the cumulative probability of those MRP. Mr. Hevert claims those charts "demonstrate that MRPs of at least 10.32 percent (the high end of the range of MRP estimates in my Direct Testimony) have occurred [or in the case of the cumulative probability, will occur] nearly half the time." (Co. Ex. 7.0, pp. 45-46)

Mr. Hevert's argument is misleading. It implies that 1) 10.32% is the median historical market risk premium; and 2) expected historical market risk premium equals the median rate of return. Neither is true. First, Mr. Hevert's own work papers indicate that the median historical market risk premium equals 8.0%, not the 10.32% he used. Second, and more importantly, the expected historical market risk premium equals the mean historical market risk premium. Morningstar reports the mean historical market risk premium for the 1926-2013 period was 7.0%. (Staff Ex. 8.0, p. 25)

The Company argues, “[e]ven the highest of Mr. Hevert’s MRP estimates is statistically indistinguishable from the historical mean at a 95.00 percent confidence interval. (Co. IB, p. 51) According to Mr. Hevert’s work paper, the 95 percent confidence interval ranges from 2.63% to 11.28%. (Staff Cross Ex. 4) Yet, Mr. Hevert has not explained what it means that his highest MRP is within the 95% confidence interval of the mean historical MRP. Specifically, he does not address how confidence intervals are used, much less what a confidence interval is, and what a 95% level means (as opposed to some other percentage). However, it does not require an expert to observe that with its large width, Mr. Hevert’s confidence interval can be used to validate any MRP estimate from 2.63% to 11.28%. An interval of such breadth is useless for assessing the validity of any MRP estimate, since an MRP of 3.59% would be as valid as an MRP of 10.32%.

3. Alternate CAPM Analyses

Staff has described the problems resulting from using betas calculated over two years, or less, in a risk premium analysis. (Staff IB, p. 36-37) Specifically, a decrease in systematic risk may increase the calculated beta coefficient. (Staff IB, pp. 36-37) However, it is not necessary to identify which element of beta causes the bias in a beta estimate. (Staff Ex. 8.0, p. 23) The Commission agreed with Staff’s concerns and rejected Mr. Hevert’s two-year betas in prior cases. (Staff IB, p. 38)

The Company observes that Ms. Phipps’ five-year betas do not cover a full business cycle. (Co. IB, p. 50) Ms. Phipps explained that measuring beta over an even longer period than Ms. Phipps calculated results in lower beta coefficients. Specifically, Staff’s regression beta, measured over ten years, is 0.56 (versus a five-year beta of

0.62). Similarly, the current ten-year Value Line beta is 0.62 (versus the five-year beta of 0.72). Therefore, applying this argument would result in an even lower cost of equity estimate. (Staff Ex. 8.0, p. 22)

In response to Ms. Phipps' showing that measuring betas over periods longer than five years reduces measurement error, Mr. Hevert countered that each of the 18-month betas he calculated for the proxy companies reveal a statistically significant relationship. (Co. Ex. 7.0 Rev., p. 43) Mr. Hevert incorrectly implies by this statement that his 18-month beta estimates are accurate. Ms. Phipps explained that the t-statistic does not test the predictive ability of the model (*i.e.*, the ability of market stock returns to predict gas sample stock returns). The t-statistic measures the extent to which an estimate differs from zero; hence, the higher the beta, the higher the t-statistic. Therefore, the statistical information Mr. Hevert provides does not indicate the validity or the accuracy of his beta estimate. (Staff Ex. 8.0, p. 23)

Notably, the 18-month betas that Mr. Hevert calculated for the proxy group range from 0.70 -1.20, with four estimates exceeding 1.0. (Co. Sch. 7.16) This implies that the proxy group companies are riskier than the market as a whole. Mr. Hevert attempts to justify his excessively high 18-month beta estimates by arguing that utilities "perhaps even faced relatively elevated risk compared to the overall market as interest rates rose during the second half of 2013." (Co. Ex. 7.0, p. 43) To the contrary, as Ms. Phipps demonstrated, there is no merit to Mr. Hevert's claim that his inflated 18-month beta estimates are the result of elevated risk compared to the market. According to Value Line, these stocks, as a group, are the safest, most stable and least risky investments relative to the Value Line universe, which accounts for about 95% of the market capitalization of all stocks in the U.S. Similarly, Moody's Investors Service and Standard & Poor's also view natural gas distribution utilities as low risk entities. (Staff Ex. 8.0, pp. 23-24)

For all the foregoing reasons, Mr. Hevert's alternative CAPM should be rejected in this case, as it has been in prior cases.

C. Bond Yield Plus Risk Premium

The Company claims that Mr. Hevert's bond yield plus risk premium analysis corroborates the reasonableness of his DCF and CAPM estimates. (Co. IB, p. 52) The Company's claims are baseless, for the reasons set forth in Staff's Initial Brief. (See Staff IB, 39-40). Even the alternative bond yield plus risk premium analysis that Mr. Hevert presented in rebuttal testimony (which uses a 2011 to present measurement period and includes credit spreads as an additional independent variable) fails to address Staff's concerns regarding his bond yield plus risk premium analysis. (Co. Ex. 7.0, pp. 48-49; Co. Sch. 7.17; Staff Ex. 8.0, p. 26) Mr. Hevert's alternative model is no better than his original analysis since it predicts that the cost of equity is inversely related to the 30-year U.S. Treasury bond yield when the U.S. Treasury bond yield is 3.73% or lower (versus a 2.90% inflection point in his original analysis).[7] This is not consistent with the positive relationship that one would reasonably expect to exist between the cost of equity and U.S. Treasury bond yields – *i.e.*, the cost of equity would increase as the 30-year U.S. Treasury bond yield increases. The counter-intuitive

[7] The 30-year U.S. Treasury bond yield was 3.73% or below 160 business days during 2014; 184 business days during 2013; 250 business days during 2012; and 99 business days during 2011. *See* Federal Reserve Bulletin, daily historical 30-Year U.S. Treasury bond yields.

relationship between bond yields and implied risk premiums indicates that Mr. Hevert's alternative risk premium model is not useful for checking, let alone estimating, the cost of common equity for gas utilities. (Staff Ex. 8.0, pp. 26-27)

The Company asserts the Commission "has recognized the value of observing general market conditions and trends, including the recent average of authorized ROEs, when assessing parties ROE recommendations." (Co. IB, p. 53) Yet, the Company's argument is flawed in that it fails to recognize the shortcomings of relying on authorized ROEs to estimate the cost of equity. That is, the Company's analysis assumes all other factors affecting a utility's credit rating are equal (*e.g.*, future test years, tariff riders, ratemaking adjustments to capital structure and recoverable expenses), which is not a realistic assumption. Thus, the Commission should reject the Company's bond yield plus risk premium analysis again. (Staff IB, p. 39)

C. Recommended Overall Rate of Return

For all the reasons set forth in Staff's IB and this Reply Brief, the Commission should adopt Staff's recommendation for a 6.81% rate of return on Liberty Midstates' rate base, which incorporates a 9.23% cost of common equity.

D. Ability to Satisfy Docket No. 11-0559 Condition

The Company notes a downward adjustment would be necessary if the Commission adopts the Company's actual capital structure and 10.50% cost of equity recommendation. (Co. IB, p. 56) However, Staff has explained that adopting the Company's actual capital structure would not be permissible under Section 9-230 of the Act. (Staff IB, pp. 19-20) Moreover, the Company's inflated cost of equity recommendation would not balance the interests of investors and ratepayers. (Staff IB, pp. 29-42) In contrast, Staff's 6.81% rate of return on rate base recommendation, which reflects a 9.23% cost of equity (and which produces a 9.55% pre-tax cost of capital), would satisfy the Commission's condition set forth in Docket No. 11-0559 without any further adjustment. (Staff IB, p. 43)

V. COST OF SERVICE

VI. RATE DESIGN

VII. OTHER

A. Quality of Future Rate Filings and Reports

Staff's quality of future rate filings and annual reports recommendation relates to two broad reporting areas:

1. Future Rate Filings; and
2. Supplements to Form 21 ILCC, the annual report submitted to the Commission.

Staff acknowledges and appreciates the Company commitment to improve the quality of its future rate filings. (Co. IB, pp. 61-62)

With respect to the second recommendation to supplement the Form 21 ILCC, the utility's annual report submitted to the Commission, Staff recommended that the Commission order Liberty Midstates to provide the supplemental information to its Form 21 ILCC, beginning with the 2014 reporting period. It would not be in the best interest of either party to delay the implementation as the improvement process may encompass more than one reporting period. Therefore, Staff recommends that the Commission order Liberty Midstates to provide annually with its Form 21 ILCC submission, the supplemental information identified on pages 54-55 of its IB (and further identified as items 1-18 and the FERC Form 2 reporting requirement) beginning with the 2014 reporting year.

B. Property Taxes – Request for Deferred Accounting[8]

The Commission should deny Liberty Midstates' request for deferred accounting treatment for property taxes (on a yet to be constructed office building) paid between now and its next rate case. (Staff IB, pp. 57-60) Liberty proposed that in its next rate case the Company would recover one year's worth of amortization of its deferred property tax expense in operating expenses and the unamortized portion would be included in rate base. (Co. Ex. 9.0, p. 4)

In its IB, Staff opposed Liberty Midstates' request because adopting the proposal would violate test year rules by mismatching revenues and expenses from different periods and also violate the prohibition against single issue ratemaking. (Staff IB, pp. 57-60) In support of its position, Staff cites two Commission orders and one Illinois Supreme Court decision. First, in Docket No. 93-0408, the Commission refused to initiate a rulemaking because the recovery of the proposed deferred expenses would violate test year rules. (Central Illinois Public Service, ICC Docket No. 93-0408 (Oct. 19, 1994) In Docket No. 98-0895, Citizens Utilities request for approval for deferred accounting treatment of its potential computer problems associated with the new calendar year 2000 ("Y2K") costs was denied because it improperly matched expenses from a non-test year with revenues from a test year. (Citizens Utilities Company of

[8] No longer an operating expense issue.

Illinois, d/b/a Citizens Water Resources, ICC Order Docket No. 98-0895, (March 15, 2000) ("Citizens Utilities") Liberty Midstates' request would also violate the Illinois Supreme Courts rule against single issue ratemaking because it would defer selected elements from the revenue requirement formula for later consideration. (Business and Professional People v. Commerce Commission, 146 Ill.2d 175 (1991) ("BPI II"))

In its IB, Liberty Midstates argues that it can distinguish the property tax expense on its future office building from previous cases before the Commission. First, the Company opines that the 2015 test year is the only year in which the building is in operation and the property tax is not assessed. (Co. IB, p. 64) The Company further states that "[i]n any other year, the property taxes will be assessed and paid." (Co. IB, p. 64) The latter statement is not totally correct – the initial assessment is expected in 2016 with the first payment in the third quarter of 2017. (Staff Ex. 1.0, p. 10 and Attachment A (Company Supplemental Response SRK 4.03)) Notwithstanding that statement, the fact remains that Liberty Midstates will not incur any property tax on its proposed office building during the 2015 test year and to allow the recovery of any such deferral would create a test year violation because the proposal would mismatch expenses from one period with revenues from another.

The second distinction that Liberty Midstates attempts to make is to distinguish its proposed property tax deferral from the Citizens Utilities' proposal to defer its Y2K costs. The Company argues that the Y2K costs are distinguishable because they are one-time, non-recurring costs, which would not be incurred year after year. (Co. IB, 64) Staff fails to see the distinction. Just as the Commission ruled in Docket No. 98-0895 that, "(c)learly, the cost at issue are *operating expenses*"…(Citizens Utilities, ICC Order

Docket No. 98-0895, (March 15, 2000) *emphasis added*), the relief sought by Liberty Midstates in the instant docket is also for the recovery of an operating expense. (Co. Ex. 5.02, line 9)

The Company raises what are essentially distinctions without differences. Both Citizens Utilities and Liberty Midstates reflect attempts to recover non-test year operating expenses in a future rate case. Therefore, Staff recommends that Liberty Midstates' request for deferred accounting for its property taxes be denied.

VIII. CONCLUSION

WHEREFORE, for all of the reasons set forth in its IB and this RB, Staff respectfully requests that the Commission's order in this proceeding reflect all of Staff's recommendations regarding the Company's request for a general increase in gas rates.

Respectfully submitted,

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